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## **Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis**

**Doreen McBarnet**

Professor of Socio-Legal Studies, University of Oxford  
Visiting Professor, University of Edinburgh<sup>1</sup>

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Glasgow University, 29–30 March 2009.*

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### **Abstract**

A much repeated strand of analysis in the banking crisis has been the issue of financial engineering gone wrong. Problems are attributed to innovative financial products so complex that risk and even ownership became untrackable. Characterising the financial products and transactions that led to the crisis primarily as financial engineering, however, tends to gloss over the other innovative skills and creative participants involved in their construction. This paper demonstrates that the significant practices behind the banking crisis involved not just financial engineering but legal engineering, legal engineering designed to systematically thwart regulation and bypass regulatory control. The paper, first, analyses the role of legal engineering in the banking crisis, showing it to have been a conscious strategy in which regulatory circumvention, complexity and opacity were integral parts. It then sets out some specific implications for future practice in business, government, regulation and the professions, and argues the need not just for new law and regulation, but more fundamentally for a new respect for the rule of law, for a new legal integrity, in both business and the professions.

### **Keywords**

Law, sociology, regulation, finance, banking, lawyers, profession, banking crisis, responsibility, compliance

One strand of analysis in the banking crisis has been the issue of financial engineering gone wrong. Problems are attributed to innovative financial products that were too readily believed to disperse risk<sup>2</sup>, backed by mathematical models<sup>3</sup> that senior banking executives took at face value, without, it's said, questioning or even comprehending them.<sup>4</sup> The financial structures set in place were so complex that risk<sup>5</sup> and even ownership became untrackable.<sup>6</sup> People were blinded by 'disaster myopia'<sup>7</sup> and indeed market ideology.<sup>8</sup> There was a dominant belief in the rationality of the market and a collective failure to recognise the limits of market, maths and risk management. Regulators are portrayed as carried along on this tide of false confidence, regulating through only a light touch with the focus on internal and market controls, and encouraged, or instructed,<sup>9</sup> by politicians to do so. People questioning the reality of the emperor's new clothes were dismissed as the ones who did not understand, lacking the sophistication to handle the magic of financial engineering. The subsequent crisis has revealed that the emperor was indeed unclothed, and the demand is for tougher regulation to stop this situation recurring, though with concerns, even in the throes of crisis, that regulation should not be so heavy handed as to stifle the lifeblood of financial innovation.<sup>10</sup>

Characterising the financial products and transactions that led to the crisis primarily as financial engineering, however, tends to gloss over the other innovative skills and creative participants involved in their construction. A crucial component of the new banking products was legal creativity. The legal work behind such practices as securitisation was not confined to drafting the contracts to sell on risk. It was also about creatively removing the 'obstacles' of prudential regulation, accounting requirements and other legal and regulatory constraints intended to control or disclose risk. Indeed circumventing capital adequacy regulation was a crucial driver behind much structured finance.

This paper seeks to reconceptualise the significant practices behind the banking crisis as not just a matter of financial engineering but a matter of legal engineering, legal engineering that is common practice in all sophisticated business. It seeks to set the financial crisis in the context of

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<sup>2</sup> Adair Turner, chairman FSA, 'The financial crisis and the future of financial regulation', *The Economist's* Inaugural City Lecture, 21 January 2009

<sup>3</sup> Jill Teanor, 'Toxic shock: how the banking industry created a global crisis', *Guardian*, 8 April 2008

<sup>4</sup> Bridget Hutter, and Nigel Dodd, 'Social Systems Failure? Trust and the credit crunch' (December 2008) *Risk and Regulation* 4; Roman Tomasic, 'Beyond "light touch" regulation of British Banks', *Conference on the Future of Financial Regulation*, Glasgow University, 29-30 March 2009.

<sup>5</sup> 'Product complexity has introduced increased opacity into our financial system, making it almost impossible to determine where risk lies and making it much more difficult to achieve financial stability' John McFall, chairman, House of Commons Treasury Committee, quoted by Alan McDermid, 'Banks "refused to believe the good times were about to end"', *The Herald*, 3 March 2008

<sup>6</sup> Stephen Schwarcz, 'Protecting financial markets: lessons from the subprime mortgage meltdown', Duke Law School Legal Studies Research Paper no 175, March 2008. Failure was exacerbated because ownership could not be tracked in order to restructure.

<sup>7</sup> See for example, John Plender, 'Analysis: Error laden machine' *Financial Times*, 3 March 2009

<sup>8</sup> Robert Peston, *Today*, Radio 4, 18 March 2009

<sup>9</sup> Adair Turner, chairman FSA, was reported as saying the FSA was put under pressure by Gordon Brown not to be 'heavy and intrusive', to make regulation 'more light touch', *Daily Telegraph*, 26 February 2009

<sup>10</sup> IMF, *Global Financial Stability Report*, 2007, p126. E Englelen, I Erturk, J Froud, A Leaver, K Williams, 'Reconceptualising Financial Innovation', *Conference on the Future of Financial Regulation*, Glasgow University, 29-30 March 2009.

the wider practice of creative transaction structuring in which the driving characteristic is to deliberately and systematically thwart regulation and bypass regulatory control. The analysis is based on<sup>11</sup> documentary analysis and on interviews over a long period of years at major companies, banks, accountancy and law firms, in the context of a wide range of regulatory, tax and accounting issues, although the interviews quoted from here relate specifically to banking. These were conducted before the banking crisis and give some insight into the legal practice and culture that I would argue contributed to it. The focus is sociological rather than legal. It explores the practice of legal engineering, and the attitude to law and compliance at its core. It is therefore concerned less with banking regulations than with how banks and their lawyers have reacted to them, and it is less about the financial instruments created than about the motivations behind them, depicting them as part of a pervasive strategic response to regulation, which itself needs to be critically reviewed.

Reconceptualising the issue as one of creative legal circumvention rather than simply financial innovation suggests a different set of issues that need to be addressed in the wake of the financial crisis. This paper, first, analyses the role of legal engineering in the banking crisis, showing it to be a conscious strategy, in which regulatory circumvention, complexity and opacity were integral parts. It then sets out some specific implications for future practice in business, government, regulation and the professions, and argues the need not just for new law and regulation, but more fundamentally for a new respect for the rule of law, for a new legal integrity.

### **Legal Engineering, intent and complexity**

A prime excuse for the financial crisis has been that those involved simply did not understand the complex financial instruments in use or realise the risk, organisational and systemic, they were creating. It is hard not to see this incomprehension as, in the kindest interpretation, a willing suspension of disbelief. Like the courtiers in the tale of the emperor's new clothes, a lot of people were doing rather nicely out of this apparently misunderstood scenario. Indeed it might be fairly argued that if senior banking executives, taking vast rewards for the stewardship of their businesses, did not understand the products at their core, they ought to have, and a failure to probe was itself, to the layman if not the lawyer, a failure of duty.

What is clear, however, is that the image of financial disaster as the result of ignorance or of unintended consequences simply does not wash when we view the innovative financial instruments through the lens of legal rather than just financial creativity. The legal creativity involved was knowingly and deliberately aimed at avoiding laws and regulations put in place to

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<sup>11</sup> This research was carried out over a period of some 25 years, in a series of projects on business regulation, in particular in the areas of corporate finance, creative accounting (especially off-balance sheet financing in both corporate and banking sectors) and tax avoidance, and covering issues in the UK, the European Union and the US. The projects all involved in-depth interviews with a wide range of big firm lawyers and accountants, bankers, corporate executives, in-house counsel and regulators. See, for examples of the work, D McBarnet *Crime, compliance and control* (Aldershot, Ashgate Dartmouth, 2004). One key issue to emerge from that research was the routine practice of 'creative compliance' and it was the role of creative legal work in accomplishing that which became one of the key issues researched under the ESRC professorial fellowship (RES-051-0031). The broad analysis in this paper is therefore based on a whole range of research projects over many years while the interviews quoted took place as part of research conducted in 2004 and 2006-07.

control risk and to ensure its disclosure. Of course regulators may have been lax and regulations insufficiently demanding, too permissive, perhaps naïve. But the fact of the matter is that however the regulations had been formulated they would have met with the same response: here is a constraint; how do we gain a competitive advantage by getting round it?

Finding arguably legal ways round legal and regulatory obstacles is a key function of the lawyer's role for sophisticated clients such as banks, and sophisticated legal circumvention has been integral to the construction of innovative financial products in banking. As one banking lawyer put it in interview:

The traders talk to people in the marketplace. "What problems do you have at the moment, what would you really need if you could have something devised for you?" Then they look at pricing models, and mathematical models, and then the next stage is the law. This could be very good, very lucrative, what legal hurdles are there?<sup>12</sup>

Or again:

The credit group at [X] Bank is a specialist structured group in the capital markets which focuses on credit instruments to securitise and it's a wonderfully lucrative business, but there are lots of laws, regulations and concepts and natural justice principles which, you know, inconveniently get in the way and they have to be reformed or modified or creatively dealt with.<sup>13</sup>

These quotations articulate particularly clearly a culture and approach to law which is not always so baldly verbalised but which is clearly and consistently demonstrated in the practice of legal work described to me over many years in corporate and professional interviews. Regulation is an obstacle to be overcome. In the particular context of banking, laws and regulations that obstruct financial engineering have to be removed by legal engineering: 'If law is inconvenient to the economic features of the proposal the lawyer must get round it.'<sup>14</sup>

### *The banking crisis in context*

Legal engineering lies at the heart of the banking crisis, and there is nothing new or unique about the practice. In that sense the banking crisis needs to be seen in a wider context. It is just part of an approach to law that has been pervasive in business over a long period of time and in a range of contexts, and there have been warnings enough of the dangers inherent in it, notably via Enron.<sup>15</sup>

Problems created by securitisation of subprime assets have constituted one of the key triggers of the banking crisis. Securitisation is a form of off-balance sheet financing (OBSF), and both OBSF in general and securitisation in particular can be seen as prime examples of a longstanding

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<sup>12</sup> Research interviews 2004

<sup>13</sup> Research interviews 2004

<sup>14</sup> Research interviews 2004

<sup>15</sup> D McBarnet 'After Enron: will whiter than white collar crime still wash?' (2006) 46 *British Journal of Criminology*; Bethany McLean 'Enron was the pit canary but its death went unheeded', *Guardian*, 4 October 2008

practice of legal engineering to deal with ‘obstructive’ laws. Though both securitisation and OBSF in general have been defended as, properly used, of real value to business and society, they have also been systematically and pervasively exploited over a long period of years as a deliberate means of undermining attempts at regulatory control.

OBSF, particularly through the use of the ‘special purpose entities’ (SPEs) or ‘vehicles’ (SPVs) that feature so centrally in securitisation – separate companies or other legal forms that have been carefully constructed to be technically legally distinct from the originating company - has a long history. It has been widely used in corporate creative accounting as a technique for consciously circumventing company law obligations to disclose a ‘true and fair view’ of corporate finances to shareholders. It has been used to keep debts or liabilities out of the accounts, enhancing apparent performance and misleading the market. Since accounts are used as the basis of all sorts of further specific corporate governance controls, OBSF has also been used to circumvent them. Bank loan covenants might stipulate tolerance of only a certain level of debt to equity before a loan can be called in. Keeping debt off the books – even if it might ultimately come back to haunt the company in the future – removes this control. It has also meant the negation of shareholders’ rights, often written into the company’s memorandum and articles of association, to call an EGM if a particular debt/equity ratio is exceeded. Performance related pay and bonuses have also been magnified by profits and growth reported in the books, even if they had no fundamental economic substance.<sup>16</sup>

Banks have played a key role not only in engineering their own OBS practices but in creating and very actively marketing schemes to corporate clients to relieve the client’s books of liabilities and losses with all the advantages just noted. Many corporate interviewees in my research emphasised the active role of investment banks in corporate OBSF schemes, sometimes indeed, in hindsight in more recent interviews, with some vituperation. One major bank’s head of compliance complained about:

the snake oil salesmen from the investment banks coming in and saying “Everyone’s doing this, why aren’t you?” putting enormous pressure on young directors.<sup>17</sup>

Banks were also active participants both in corporate-initiated schemes and in the schemes they were purveying themselves. They would, for example, play the crucial role of independent third party in the structuring of an SPV, this being a key element in meeting the criteria that would let the SPV be treated as a legal entity separate from the originating company. Or they might temporarily buy liabilities to get them off the client’s balance sheet at a legally significant moment.

Banks could indeed be in the interesting situation where one department of the bank was actively marketing a device to take debts off a client’s balance sheet, so undermining the covenants of the bank loans lent by another department of the same bank. It might be worth noting here the wider implications of the banks’ role in general corporate off-balance sheet financing. It was not just bank risk which was disguised but general corporate indebtedness and therefore corporate

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<sup>16</sup> D McBarnet and C Whelan, *Creative Accounting and the Cross-eyed Javelin Thrower* (Chichester, John Wiley, 1999)

<sup>17</sup> Research interviews 2007

vulnerability in the face of the kind of credit crunch the banking crisis has produced. Banks' OBSF activities have played a part in the economic and not just the financial crisis.

Banks were also heavily implicated in Enron's OBSF practices, a fact that led to some interesting developments in the deferred prosecutions that followed, of which more later.

Enron famously, or infamously, used a host of SPEs, derivatives and other creative legal devices to hide liabilities and boost apparent profits, while at the same time constructing a vast range of tax avoidance devices to the point where it received tax rebates.<sup>18</sup> Enron executives, of course, also resorted to, and were prosecuted for, fraud, but the reality is that the corporation was doing a pretty good job of misleading the market even without resort to fraud. Indeed comments at Congressional investigations repeatedly drove this point home.<sup>19</sup> Many of the devices used by Enron were standard business practice. Indeed at the 2002 annual meeting of the US Bond Market Association one member is reported as asking: 'How do we help the market distinguish between what we do and what Enron did?' The question was put to speaker Harvey Pitt, then chair of the SEC, and the report notes 'he had no ready answer.'<sup>20</sup> Enron's use of legal engineering to circumvent regulatory control was far from unique.

A single device of legal engineering can often circumvent multiple regulatory obstacles. SPEs have been used to circumvent all manner of other laws and regulations such as tax, disclosure rules in takeovers and trade embargoes. Synthetic securitisation, described in interview as 'the transfer of economic or credit risk associated with assets without transferring the assets', was credited by the interviewee as being:

helpful in the face of anti-assignment clauses, transfer restrictions under the laws or jurisdictions where the assets are located, securities law registration issues regarding transfers of assets or securities, legal investment restrictions, withholding tax and stamp duty,<sup>21</sup>

a useful tool indeed.

And of course both synthetic securitisation and securitisation in general, along with derivatives and other innovative legal structuring, gave banks an escape route from the constraints of capital adequacy regulation, an escape route that was precisely the purpose of the innovation.

### *Creative legal responses to regulation*

Regulation and regulators have been criticised strongly in the wake of the banking crisis, and with justification, but it is also important to remember that whatever regulation is put in place, business, in this case banks, will routinely respond by seeking out ways to circumvent it.

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<sup>18</sup> D McBarnet 'After Enron: will whiter than white collar crime still wash?' (2006) 46 *British Journal of Criminology*

<sup>19</sup> 'The real scandal here may be from not what is illegal, but what is totally permissible. If the GAAP allow the bookkeeping shenanigans that have been reported in the press then we should all go into the derivative business. It seems that all too often the name of the corporate game is to conceal the true financial situation of the company while doing the minimum amount of disclosure to avoid legal exposure.' (US Senate 2002, Senator Thompson).

<sup>20</sup> Andrew Osterland, 'Commercial Paper Chase' (2002), *CFO Magazine*, 1 June

<sup>21</sup> Research interviews 2004



Reviewing the history of off-balance sheet practices in banking, a 2003 report by one international bank noted:

The motivation [for OBSF] was heightened in the late 1980s by the introduction of risk-based capital guidelines for banks and thrifts.<sup>22</sup>

In this the banks were behaving no differently from any other big business. Introduce a new regulatory strategy and the business response will be a new circumvention strategy. Require companies to consolidate subsidiaries and the response is creative structures to constitute ‘non-subsidiary subsidiaries’ or SPVs that fall beyond the definition of subsidiaries. Capture in the tax net the practice of ‘bed and breakfasting’ shares to artificially crystallise tax losses and the response is share-‘weekending’ to tweak the technique using parallel but technically different criteria. Count the loans on the books as part of a regulatory risk assessment and the response is to come up with some creative legal engineering to get those loans off the books.

The first Basel concordat on banking regulation, in 1988, prompted a flurry of creativity to circumvent its constraints and indeed use it as an opportunity to secure competitive advantage through that circumvention. Legal engineering involves close scrutiny of the wording of laws and regulations in order to work out how to package a transaction in such a way that it can claim to meet the technical demands of the regulation even if the result is not what the creators of that regulation had in mind. Definitions and criteria involving clear rules or thresholds make particularly valuable material for legal engineers to work on. The criteria set out in Basel I were scrutinised in just this way and the distinction between tier 1 and tier 2 capital provided, said the FT, ‘a rich vein of material with which financial engineers have worked’<sup>23</sup> – with, it should be noted, legal engineering integral to the process.

Tier 1 capital was the safest capital with higher weighting, equity being the prime example since it did not have to be repaid in the event of crisis. The challenge therefore became how to invent an instrument which could claim to meet the tier I criteria while still attracting investors by offering them the kind of investor security that, for example, a bond would give. It had in short to do the magic trick of apparently involving no risk to either bank or investor.

One early response (1989) was the construction of preference shares with dividends which could be interrupted if the bank got into trouble. They were also, in legal form, ‘permanent’, meaning that in theory they need never be repaid, all of this enabling them to be claimed as tier 1 capital, although in practice they were structured such that they could be redeemed after five years. The attraction of this instrument was that it raised money that, it was claimed, had the same tier 1 status as equity, while avoiding the rights issue that equity raising would involve and, since it was done through an SPV, also avoiding the need to seek the approval of shareholders.<sup>24</sup> Reports on this instrument noted that the banking supervisors intended to keep a close eye on innovative instruments to prevent the Basel agreement being subverted. There were similar concerns with RBS’s early innovative floating rate notes (also 1989). The Bank of England prevaricated on whether to accept the bank’s claim that they qualified as upper tier 2 capital, allowing the first

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<sup>22</sup> Nomura Fixed Income Research *Off-balance sheet update* (11 March 2003) 2

<sup>23</sup> *Financial Times* 6 December 1990

<sup>24</sup> Barclays, reported in the *Financial Times*, 9 May 1989

issue, only to disallow further issues when the Basel Committee made it clear it saw the instrument as a threat to the regime: it ‘would open the door to a variety of innovations that might ultimately undermine the Basel Agreement’.<sup>25</sup> From the beginning, in short, there were creative challenges for the regulators which only became more sophisticated over time in response to both competition and changing regulations.

In legal engineering any new regulation is seen simply as a new challenge to be overcome. OBSF regulation was significant for the banking industry both in relation to banks’ own securitisation practices and, as we have seen, in relation to the lucrative services they were marketing to clients. So, when the US Federal Accounting Standards Board (FASB) introduced new rulings on off-balance sheet financing after Enron,<sup>26</sup> the banks’ response was not to capitulate and accept more activities would now go on the balance sheet, but, as one international bank noted in an analysis of current trends, to search for ‘practical solutions to avoid consolidation.’<sup>27</sup>

In the same 2003 document the bank analysed the new regulations to explore possible ways to avoid the consolidation they required. It suggested restructuring collateralised debt obligations (CDOs) and ABCP programmes to fall within an exclusion in the rules, which did ‘not apply to a “qualifying special purpose entity” or QSPE under FAS 140(14c)’. This approach was predictable, exploitation of exclusions and exemptions being a standard technique of legal engineering. Concern was expressed however that this would constrain the ability to actively market the asset portfolios backing the deals. Another route, the bank’s researchers suggested, looking closely at the wording of the regulation, would be:

to disperse a VIE’s [Variable Interest Entity] economic risks and benefits among many parties, so that none holds a majority of variable interests requiring consolidation

though there would be problems with this:

if third party holders of variable interests insist on having a measure of control proportionate to their economic stake.

The ideal way would be another route, finding an:

aggressive (but not manifestly unreasonable) basis for measuring variable interests in a way which does not closely correspond to their economic risks and benefits  
...[then]...dispersing variable interests without dispersing the economic risks and benefits.

Such a device, the document noted, would be the ‘holy grail’ to search for. This is just one example of how every new regulation becomes a challenge to be creatively overcome, and to be scrutinised for escape routes, usually with some success. Certainly *Accountancy Age* in 2008

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<sup>25</sup> *Independent*, 1 June 1989

<sup>26</sup> FIN 46, FASB Interpretation No 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No 51* (17 January 2003)

<sup>27</sup> Nomura Fixed Income Research *Off-balance sheet update* (11 March 2003) 1

reported a general loss of confidence within the FASB on how to tackle off-balance sheet financing: though new rules were introduced in the US after Enron, ‘the banks found a way round these.’<sup>28</sup>

Over time regulatory initiatives to control or ensure the disclosure of risk have spawned a range of new and ever more complex securitisations which let banks expand their lending without having to increase their risk capital. This has of course been argued to have real value:

Structured finance allows people to raise money they might not otherwise be able to raise, and that access to capital contributes to productivity.<sup>29</sup>

And where risk really has moved from the banks, the argument goes, then it is right to treat innovative forms as substantively and not just technically compliant. One question that arises from the current crisis, however, is how far were the risks truly removed? There is also the issue of how adequately they were disclosed. In addition, the apparently infinite capacity to lend off-balance sheet without the need for balancing capital encouraged much riskier lending than could otherwise have been undertaken. Indeed, the legal capacity to securitise itself stimulated a hunger for opportunities to create loans or other assets that could be securitised.<sup>30</sup> Rather than securitisation being built on pre-existing assets with their own economic logic, the possibility of securitisation prompted the creation of assets – such as subprime loans – to securitise, regardless of their intrinsic economic logic. Small wonder there was concomitant expansion of systemic risk.

Economic risk issues are beyond the scope of this paper, as is the adequacy of the regulations themselves. The focus of this paper is the strategic approach taken to law and regulation by the regulated, and the point there is that regulatory attempts to control bank risk were - as is routine and pervasive practice in any big business context - consciously and deliberately met by attempts to innovate out of them, and that innovation involved not just mathematical or financial creativity but legal creativity. For banks, capital adequacy regulations, designed to control risk, were ‘obstructions’ to be ‘dealt with’ through creative legal engineering.

### *The role of tax in structured finance*

This legal engineering was right at the core of structured finance. Legal engineering is what translated the financial whizz-kid’s idea into a legally and therefore economically viable product:

the potential of the product depends on the ratio of cost it would incur to get round legal, regulatory, tax or accounting difficulties<sup>31</sup>

The reference to tax is pertinent. Creative tax avoidance was a frequent driver of securitisation as well as a key element in profit and indeed in marketability. There was always a basic issue in any

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<sup>28</sup> Penny Sukhraj ‘FASB probes off-balance sheet rules’, *Accountancy Age* 29 February 2008

<sup>29</sup> Lynn Turner, former chief accountant at the SEC and professor of accounting at Colorado State University, quoted in *CFO magazine*, October 2002, [www.cfo.com](http://www.cfo.com)

<sup>30</sup> An example of insurance products being created in order to securitise them is given in the next section.

<sup>31</sup> Research interviews 2004

legal engineering of ensuring that devices intended to circumvent one set of regulations, such as capital adequacy rules, did not end up with adverse tax repercussions, and an equally basic practice of working to retain both tax and regulatory advantages even where logically the securing of one advantage should have been at the expense of the other.

Legal engineering is about having your cake and eating it too. Hybrid capital, for example, was designed to achieve both the capital adequacy advantages of equity and the tax advantages of debt. In normal usage equity would be best for the capital adequacy count but equity does not generate the tax allowable costs of debt which boost the return on equity. ‘Hybrid capital’ was conjured up to claim qualification as Tier 1 capital under the Basel framework while still being tax deductible. It is, as noted by a UK regulator:

capital that acts like debt as far as the taxman is concerned, and capital that acts like equity as far as the depositor is concerned...Market participants have been quite imaginative in devising structures that meet diverse requirements in different jurisdictions to qualify as debt for tax purposes and equity for accounting purposes.<sup>32</sup>

This indeed is parallel to the convertible bonds created in the corporate sector in the 1980s to simultaneously meet the apparently contradictory criteria of both debt and equity for different regulatory purposes.

Tax avoidance can itself be a primary driver of structured finance, and the source of the profit generated. In its 2009 ‘Tax Gap’ series, the *Guardian* reported structured finance deals, such as those where:

“investments” of £6 billion at a time...moved in circles between RBS and other banks’... [as] ... an important factor in driving the “securitisation” boom which led to worldwide financial calamity.<sup>33</sup>

Creatively structuring in tax avoidance can also be key to the marketability of the underlying assets for securitisation – and it is important to remember here that assets have sometimes been created in order to securitise them rather than the securitisation following from the pre-existence of the assets. A securitisable insurance product for example, might be dreamed up in the abstract, and successfully legally engineered. But then the insurance policies had to be sold - to give the product ‘an insurance wrap’<sup>34</sup> – and constitute the underlying asset. In marketing the policies the lure of tax avoidance for the purchasers proved key:

The objective is the securitisation but we use the legal benefits to get the policies sold. It’s sold as a cheap way for high net worth individuals to leave money to heirs, avoiding IHT [inheritance tax].<sup>35</sup>

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<sup>32</sup> Thomas Huertas, Director, Banking Sector, FSA (2008) ‘Hybrid Capital’, speech at City and Financial Bank Capital Seminar, 26 June

<sup>33</sup> *Guardian*, 13 March 2009

<sup>34</sup> Research interviews 2004

<sup>35</sup> Research interviews 2004

In a number of ways, then, the legal engineering of tax avoidance has also been a key driver of, and integral to the profit in, banks' securitisation and other structured finance transactions, and this has added further layers of complexity to transaction structures.

### *Legal engineering and the production of complexity*

In highly structured transactions of any kind – and these instruments were, as one lawyer put it, 'hellishly structured'<sup>36</sup> – there is typically complexity and opacity. So if the securitisation transactions behind the banking crisis were retrospectively deemed too complex and opaque for their risk to be comprehended,<sup>37</sup> it is hardly surprising. But a key factor in why highly structured finance *became* highly structured was the desire to circumvent regulation.

Dealing with regulatory obstacles involves complex and sophisticated legal work in long chains of transaction structures, and this is neither accidental nor incidental but inherent in the task of regulatory circumvention. A solution to one regulatory problem will inevitably throw up new legal, regulatory, accounting and tax problems, which in turn need to be dealt with. Solving them will involve the addition to the transaction structure of further complex steps or partners or legal entities or jurisdictions and the final product may indeed be a 'labyrinthine' structure that is hard to comprehend. But if financial instruments are too complex to understand, it is important to recognise that one of the reasons for that complexity is the legal engineering that lies behind them and the multiplicity of laws, regulations, taxes and jurisdictions that are being circumvented in order to avoid regulatory control.

The complexity, incomprehensibility and opacity of risk attributed to innovative financial instruments can then be characterised not simply as an unfortunate by-product of financial engineering but as an integral part of legal engineering. And whether or not there was awareness of the financial risk being created, there was most certainly a very clear awareness that the regulations intended to control and disclose financial risk were being systematically circumvented by legal engineering. That indeed was its purpose. In fact my research over the years underlined to me that the risks that primarily concerned legal engineers, whether in the corporate or the banking sectors, were not financial risks at all but 'structural risks'<sup>38</sup> – the risk that the regulatory and tax circumvention integral to the transactions might be challenged by the authorities.

## **Redefining the problem, redefining the solution**

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<sup>36</sup> Research interviews 2004

<sup>37</sup> Remember the quote footnoted in the introduction to this paper from John McFall, chairman, House of Commons Treasury Committee: 'Product complexity has introduced increased opacity into our financial system, making it almost impossible to determine where risk lies and making it much more difficult to achieve financial stability' quoted by Alan McDermid, 'Banks "refused to believe the good times were about to end"', *The Herald*, 3 March 2008

<sup>38</sup> Research interviews 2004

Reconceptualising financial innovation as legal innovation gives a different take on some of the problems underlying the banking crisis and raises different issues that need to be addressed. I'll consider the implications of this analysis for four issues:

- changing the regulations
- principles-based regulation
- the allocation of responsibility
- the relevance of current events, movements and mood.

### *Changing the Regulations*

Regulations and regulators have themselves come under fire as a result of the current financial crisis. Capital adequacy regulations have been described as inadequate and promises made that they will become more demanding.<sup>39</sup> But as we have seen in the course of this paper, any new regulation tends to be met with the same energetic drive to circumvent it, and there should be no expectation of a quick fix from increasing the capital adequacy ratios required or prohibiting specific instruments currently in use.

Legal engineering is all about getting round the rules, whatever shape they currently take. We saw instances of that earlier in this paper in our discussion of the banks' response to the introduction of new regulations on off-balance sheet financing. New regulations can simply stimulate new devices to escape them. Financial innovation has been discussed as 'bricolage',<sup>40</sup> with 'bricoleurs' using 'whatever is at hand' to construct new products from the current finite materials around them. One of those materials is law. Legal engineers use whatever law is available at any given moment, sometimes drawing from areas of law and regulation not hitherto seen as relevant to the context in hand, in order to construct new ways out of control. Law is both the obstacle to be overcome, and the 'raw material to be worked on',<sup>41</sup> in order to achieve that. However regulations are changed, they will be complied with 'creatively' and there needs to be awareness that the same could happen in the current context with new regulations unless the whole approach to compliance is addressed.

That is not to say that regulations should not be enhanced, that creative compliance cannot be made a little more difficult, that legal engineers should not be challenged by presenting them with tougher obstacles to surmount. And the pleas of ignorance at the top could be addressed. On this, lessons might be learned from the post-Enron deferred prosecutions in the US.

Several banks which had been involved in Enron's schemes, along with KPMG, were not immediately prosecuted for their roles, but were monitored under deferred prosecution

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<sup>39</sup> Eg Callum McCarthy, chairman FSA, 'Lessons from the financial crisis', speech at Manchester Business School, 13 May 2008, 3, and Mansion House Speech, 18 Sep 2008

<sup>40</sup> E Engelen, I Erturk, J Froud, A Leaver, K Williams, 'Reconceptualising Financial Innovation: frame, conjecture and bricolage', *Conference on the Future of Financial Regulation*, Glasgow University, 29-30 March 2009; D MacKenzie, 'An equation and its worlds: bricolage, exemplars, disunity and performativity in financial economics', *Social Studies of Science*, vol 33, no 6, pp 831-68

<sup>41</sup> Doreen McBarnet, 'Law and capital: the role of legal form and legal actors' in McBarnet (ed.) Law and Capital, Special Issue of *International Journal of the Sociology of Law*, Academic Press, 1984, reprinted in McBarnet *Crime, compliance and control*, op cit

agreements. Prosecution was deferred so long the firms undertook a range of obligations, with the threat of prosecution dropped after a specified time. These agreements included some obligations of direct relevance to the kind of legal engineering discussed in this paper.<sup>42</sup> Firms were, for example, required to set up committees of senior executives ('Head of Group or experienced designee') from all the 'disciplines' in the firm, to review and approve transactions, with the need for agreement of all Heads before a transaction structure was approved. This review obligation extended, to cite the Merrill Lynch agreement, to 'all complex structured finance transactions effected by a third party with Merrill Lynch.'<sup>43</sup> This requirement for the direct involvement of top management is in line with the FSA's call for responsibility at the top of organisations, it is best practice in some organisations,<sup>44</sup> and it might be a mechanism that should be given greater emphasis, especially in the wake of senior bankers' protests that they simply didn't realise what was going on or the risk it involved.

Under the deferred prosecution agreements these committees were required not just to ensure that the transactions did not technically break the law. They also had to consider their wider effects. The agreements prohibited firms from engaging in any transaction intended to 'achieve a misleading earnings, revenue or balance sheet effect'<sup>45</sup> for the corporation involved. Note the reference to 'misleading' rather than just 'fraudulent' effects. There was also a demand that in assessing these structures, there should be a shift of focus from technical compliance to a concern with the 'objectives' of the structuring, with a purely accounting or tax objective deemed inappropriate.

Given the impact of Enron at the time it is not surprising that the focus in these agreements was on the bank's role in facilitating OBSF deals for other corporations. Hence the concern with third party transactions and with the effects on the third party's accounts. But there is no reason why the same standards could not be set for monitoring a bank's own transactions and the effect on its own balance sheet. The underlying concept was that it was not enough for a transaction to be, under a strict or literal reading of the law or regulation, technically not illegal. There needed to be some responsibility taken too for its wider purpose and effects. This reflected public concern at the time not just over Enron's fraud but over the whole idea of legally engineered structures that could claim to be 'perfectly legal', or 'not illegal', but nonetheless defeated regulatory policy. The same public concern is clear now in relation to banking practice itself.

### *Principles-based regulation*

As a result of the banking crisis, principles-based regulation – the flagship approach of the FSA – has come in for severe criticism. Julia Black has described the approach as having suffered 'a potentially fatal blow'.<sup>46</sup> Indeed FSA officials themselves have declared principles-based regulation a failure in that 'a principles-based approach does not work with individuals who have

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<sup>42</sup> See for a detailed analysis, D McBarnet 'After Enron: will whiter than white collar crime still wash?' (2006) *British Journal of Criminology* 46, issue 6

<sup>43</sup> US Department of Justice 'Enron Task Force Agreement with Merrill Lynch on Deferred Prosecution' (2003)

<sup>44</sup> Research interviews 2007

<sup>45</sup> US Department of Justice 'Enron Task Force Agreement with Merrill Lynch on Deferred Prosecution' (2003)

<sup>46</sup> Julia Black, 'The death of credit, trust – and principles-based regulation?' (December 2008) *Risk and Regulation*,

no principles'.<sup>47</sup> But critics seem to be equating principles with soft touch regulation and the two do not necessarily have to coincide.

There are different philosophies and strategies behind principles-based regulation. Sometimes the approach is to provide a broad goal in order to allow for variations in detail or implementation. This approach characterises regimes bent on harmonisation of different bodies of regulation, and is often a way of achieving broad harmonisation – or the appearance of harmonisation – without every party having to agree on every detail. It can be a product of political expediency, or of an approach which finds it more appropriate to delegate detail to a lower regulatory rung. The FSA's approach – and it was also bringing into one regime a range of different organisations with different regulations – was to set very broad behavioural standards but allow for variation in the methods used to achieve those standards, allowing a broad sweep of *laissez-faire* so long as the 'outcomes' met the goals. This exhibited a great deal of trust in the regulated and their ability to self-regulate, and it tied closely with the dominance of market ideology.

There can be another philosophy behind principles-based regulation however, where it is driven not so much by trust in the regulated and their capacity for restraint, but by distrust, based on experience, and by the need for *constraint*. Driving this approach is an explicit recognition that any specific rule will be met by legal engineering to circumvent it, and principles-based regulation is seen as the only realistic response, the only way to try to capture the spirit of the law in the face of constant creativity and technical challenge. This approach featured to some extent in the FSA's adoption of principles-based regulation but it was the overwhelming driving force behind the adoption of this style of regulation in the 1990s by the Accounting Standard Board (ASB). For the ASB principles-based regulation was an essential bastion against opportunistic legal engineering.

It would be unwise in the extreme for the FSA to abandon the idea of principles-based regulation because of the current debacle. A reversion to rules will simply result in legal engineers developing ways out of them with bright line rules to point to in their defence. Creative compliance thrives on rule based regulation, for tight specific rules provide particularly solid material for legal engineers to work with.

Importantly, though, principles will certainly not stop legal engineering if they are not strongly enforced. The ASB emphasised the need for principles to control creative compliance with law and regulation through legal and accounting engineering. However the body responsible for enforcing accounting standards, the Financial Reporting Review Panel (FRRP) was not noted for its use of principles in its enforcement practices, tending instead to monitor for and enforce compliance with specific rules. ASB chairman David Tweedie frequently stated that the requirement in company law to give a true and fair view in accounts should override even compliance with specific rules if such compliance did not result in a true and fair view of the financial situation. However, research<sup>48</sup> on the FRRP's enforcement practice showed that it did not use the 'true and fair' requirement in this way. The Panel quite frequently refused to accept situations where a company had invoked the override as a reason for not following specific rules.

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<sup>47</sup> Hector Sants, chief executive FSA, speech at Thomson Reuters, 12 March 2009, *Guardian*, 13 March 2009

<sup>48</sup> D McBarnet and C Whelan *Creative Accounting and the Cross-eyed Javelin Thrower*, John Wiley, 1999



But there were no instances of the Panel doing the opposite, that is, itself using the override to reject a company's technical compliance if it was not deemed to result in a true and fair view of the accounts, though it was for this situation that Tweedie had particularly advocated its use.

The FSA has used principles as a means of enforcement in cases where there were deemed to be unacceptable effects even though there was arguably no breach of a specific rule. In one case there was no specific rule to deal with the situation. In the other the infringement took place outside FSA jurisdiction.<sup>49</sup> Using principles in this way helps tackle the kind of legal engineering which takes advantage of an absence of rules, and innovates into a vacuum. But it would take more to challenge legal engineering based on a claim to technical compliance with extant rules, despite the fact that the net result is not what was intended. For that approach to be challenged, principles need to be brought in not just to fill a vacuum in the book of specific rules but to override the rulebook if the principles have not also been met. That is the only way to ensure technical compliance with the letter of the law is subjugated to a requirement to comply with its spirit. And to be meaningful this would have to be the basis not just of regulatory rhetoric but of regulatory enforcement.

However too much can be expected of principles-based regulation. It is difficult to enforce principles. There is not always consent on whether a practice constitutes compliance with the spirit of the law.<sup>50</sup> Some financial products seem to have left regulators stumped as to whether or not they are legitimate. Thomas Huertas, Director of the Banking Sector of the FSA, discussing hybrid capital, pondered on whether it was 'admirable alchemy or invidious innovation.'<sup>51</sup> There is a real reluctance to use principles in enforcement because of the criticisms of subjectivity, retrospectivity and too much power being usurped by regulators, and even principles and broad abstract concepts take the form of words which can still provide material for legal engineers to work on.<sup>52</sup>

Principles should not be abandoned, but neither are they the panacea. Indeed underlying the issue of principles or rules is a more fundamental problem: the culture that fosters legal engineering and its presumption of legitimacy.

### *Legal engineering and Responsibility*

The rule of law may be seen as a fundamental of democratic society, but that is not how it is approached in the practice of legal engineering. In the mindset of the legal engineer, law or regulation is not a legitimate and authoritative command to be taken at face value, respected and obeyed. It is simply a nuisance, an obstacle to be overcome, a material to be worked with and reshaped to one's advantage, a challenge in a regulatory cat and mouse game.

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<sup>49</sup> Citigroup and Deutsche Bank, 2006. In the case of Citigroup there is no suggestion that a specific rule was infringed. In the case of Deutsche Bank the infringements occurred in foreign markets not regulated by the FSA, so that the FSA's specific rules did not apply. Enforcement took place by invoking FSA principles.

<sup>50</sup> Though it is sometimes forgotten that can be equally true of specific rules.

<sup>51</sup> Thomas Huertas Director, Banking Sector, FSA (2008) 'Hybrid Capital', speech at City and Financial Bank Capital Seminar, 26 June

<sup>52</sup> 'When compliance is not the solution but the problem: from changes in law to changes in attitude', in V Braithwaite (ed) *Taxing Democracy*, Ashgate, 2003, reprinted in McBarnet, *Crime, compliance and control*, op cit

Legal engineers know they are not following the intentions or spirit of the law. Bankers and banking lawyers talk in interview about their legal practices as ‘bullish’ or ‘sailing close to the wind’. Indeed they are sometimes surprised when they succeed, when regulators fail to see through what a lawyer described as the ‘fog’ of complexity and opacity, a fog which indeed can be developed for just that purpose. In the mindset that underlies and fosters legal engineering, all the responsibility for control is being placed on the regulators. If they can’t make regulations legal-engineering proof or spot the failings in the schemes it is fair game to exploit that situation. Ideas such as responsibility, the public good, morality, ethics or integrity do not enter into the equation. All, it seems, is fair in love and law.

But should all the responsibility for securing compliance rest with writers and enforcers of regulation? Or should the regulated too not be seen as having a responsibility to comply with the spirit of the law? Black describes the regulations on capital adequacy as too easy to get round.<sup>53</sup> But that takes as given the culture of circumvention. The present crisis may indicate it is time to question that culture and its legitimacy and to place more responsibility for the efficacy of regulation on the regulated.

What this paper has reminded us of too is the behind-the-scenes but active and crucial role of the legal profession in creative compliance. At the core of financial engineering is legal engineering which depends heavily on lawyers and legal work. Professional responsibility therefore also needs to be questioned and the meaning of professional ethics in relation to the rule of law addressed.

If the legitimacy of legal engineering and creative compliance is to be reassessed, politicians also need to put their own house in order since they have been as guilty of legal engineering, creative compliance and disrespect for the law as banks and corporations have. Politicians and governments have themselves thoroughly exploited this ‘bullish’, technical and literal approach to law, not just in such practices as the careful technical packaging of party donations as loans in the ‘peerages for loans’ scandal, but also in core financial policy. UK Prime Minister Gordon Brown has said he wants:

all companies to bring out their bad assets and put them back on their balance sheet so the financial system can move forward.<sup>54</sup>

Yet for years the government itself used off-balance sheet financing techniques in the form of the Private Finance Initiative to enhance public accounts. There is more than a whiff of hypocrisy in politicians denouncing such activities as tax avoidance and off-balance sheet financing while themselves using the letter of the law to defeat its spirit. If a more responsible approach to the rule of law is to be encouraged there must be more of what corporate responsibility consultants and regulators have referred to as ‘tone at the top’.<sup>55</sup>

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<sup>53</sup> Julia Black, ‘The death of credit, trust – and principles-based regulation?’ (December 2008) *Risk and Regulation*, 8

<sup>54</sup> Institute of Financial Accountants website, ‘Gordon Brown has vowed to force banks and other businesses to put their off-balance sheet liabilities into their books’, 25 September 2008, [www.ifa.org.uk/news](http://www.ifa.org.uk/news)

<sup>55</sup> ‘Tone at the Top: Getting It Right’ (Speech delivered at the Second Annual General Counsel Roundtable, Washington DC, 3 December 2004).

### *Carpe diem*

There has been a growing regulatory rhetoric, especially since Enron, for a more ethical stance in relation to law and compliance and for greater emphasis on compliance with the spirit of the law.<sup>56</sup> The financial crisis may provide an opportunity – if, and it's a very big 'if', the political and professional will is there - to shift from rhetoric to practice. The banking crisis has added force to a public discontent with business that began with Enron, a discontent that demonstrates growing awareness of, and strong objections to, the practice of technical compliance with the letter but not the spirit of the law, and the lack of basic ethics in business and public life. Recent UK experience over politicians' approach to expenses has strengthened this public mood to a level of public disgust that could be harnessed to change. Taxpayer funding of banks could also provide an opportunity for setting new standards of social and legal responsibility in the banking sector itself.

There are also other trends and forces at work that might be harnessed. The corporate social responsibility movement has been expanding its agenda beyond pressures for environmental responsibility and human rights to concerns with a more ethical approach in business to finance and to legal compliance. This has been expressed particularly in the context of tax avoidance but has the potential to be harnessed too to a wider critique of cavalier approaches to law – by business, professions or politicians – and to a call for compliance with the spirit of the law.<sup>57</sup> The banking crisis has demonstrated that clever manipulation of law and circumvention of regulation may not be quite so clever after all, and that its social costs can be devastating. There is a growing awareness of the unfairness by which those with the resources to do so can buy their way out of legal control at the expense of those who cannot.

The time may be appropriate for a new aspiration towards a greater respect for the rule of law, a greater respect for democracy in law, and a new legal integrity. Certainly it will require a shift as fundamental as that, and not just some tinkering with the rules, for there ever to be any hope of effectively regulating banking or indeed business in general.

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<sup>56</sup> D McBarnet, 'Compliance, ethics and responsibility: emergent governance strategies in the US and UK' in J O'Brien (ed) *Private equity, corporate governance and the Dynamics of Capital Market Governance* (London, Imperial College Press, 2007)

<sup>57</sup> For a detailed analysis see Doreen McBarnet 'Corporate Social Responsibility beyond law, through law, for law: the new corporate accountability' in McBarnet D, A Voiculescu, T Campbell (eds) *The new corporate Accountability: Corporate Social Responsibility and the law* (Cambridge, Cambridge University Press, hardback 2007, paperback 2009)

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